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SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST

What is a Sale to an Intentionally Defective Grantor Trust?

A sale to an intentionally defective grantor trust involves the creation of an irrevocable trust that is a "grantor trust" for income tax purposes. A "grantor trust" is a trust that is structured so that all items of income, deduction and credit generated by the trust are taxed to the creator of the trust (*i.e.*, the "grantor") for income tax purposes. The result of grantor trust status is that the trust is ignored for income tax purposes and, as a result, the trust's income, deductions, and credits are passed through the trust to the grantor and reported on the grantor's individual income tax return rather than to the trust as a separate entity. Although the trust is a "grantor trust" for income tax purposes, the trust is structured so that the trust assets are not includable in the grantor's gross estate for federal estate tax purposes.

After creating the trust, the grantor sells assets to the trust at their fair market value in return for a promissory note that bears interest at the applicable federal rate sanctioned by the Internal Revenue Code. At the end of the note term, any income and appreciation on the trust assets that exceeds the payments required to satisfy the promissory note passes to the beneficiaries of the trust (usually the grantor's children and/or grandchildren) free of estate, gift and, if appropriately structured, generation-skipping transfer taxes.

Creation of the Irrevocable Grantor Trust

Upon creation of the irrevocable grantor trust, the grantor should fund the trust with cash or other assets. In order to support the assertion that the eventual sale is a bona-fide sale, most estate planning commentators suggest that the trust should initially be funded with assets equal to at least ten percent (10%) of the face amount of the promissory note (because an independent third party would not sell assets to a trust in return for a promissory note if the trust only had nominal assets). The conventional wisdom is that assets equal to ten percent (10%) of the face amount of the note should provide the trust with the financial means to pay off the note if there is an unexpected decline in the value of the trust assets.

Alternatively, the assets could be sold to an irrevocable grantor trust that already exists. In such a case, the trust already will have assets, so that the grantor need not transfer assets to the trust prior to the sale.

Ideally, when selling assets to the trust in return for a promissory note, the note will be structured as a "balloon note," where repayment of the principal is deferred until the end of the note term. Therefore, the trust will make only annual interest payments to the grantor. By using a balloon note, a larger percentage of the assets remain in the trust during the note term, thereby allowing the greatest compounding of appreciation inside the trust.

Tax Consequences of the Sale to an Intentionally Defective Grantor Trust

Gift Tax. The initial funding of the trust will be a taxable gift; however, the grantor can use (if available) a portion of his or her gift tax exemption to shelter the gift from tax.

The sale of assets to the trust in return for a promissory note will not be a gift as long as the promissory note equals the value of the property transferred and bears interest at the applicable federal rate. The applicable federal rate changes monthly, and the rate to be used depends also on the term of the note.

Estate Tax. The trust is designed so that the trust assets will be excluded from the grantor's gross estate for federal estate tax purposes. If the grantor dies before the note is fully paid, then the balance due on the note will be included in the grantor's gross estate. Post sale appreciation on the trust assets, however, will not be subject to estate tax.

Generation-Skipping Transfer Tax. The trust can be designed so that the trust assets are exempt from the generation-skipping transfer tax (the "GST tax"). The GST tax is imposed at the maximum estate tax rate (50% in 2002) on transfers to or for the benefit of an individual two or more generations below that of the grantor (*e.g*., the GST tax is imposed on gifts and bequests to the grantor's grandchildren and more remote descendants). Nevertheless, each individual has a GST exemption amount that can be used to shelter assets from the GST tax. The grantor can allocate a portion of his or her GST exemption to the assets used to fund the trust and thereby shelter the entire trust from the GST tax.

Income Tax. As discussed above, the trust is designed to be a grantor trust for income tax purposes. This means that transactions between the grantor and the trust have no income tax consequences (because the grantor is treated for income tax purposes as if he or she still owns the trust assets). The transaction has the following income tax ramifications:

Because transactions between the grantor and the trust have no income tax consequences, no gain or loss is recognized on the sale of assets to the trust in return for the promissory note. As the sale is ignored for income tax purposes, the income tax basis of the assets sold to the trust will not change as a result of the sale.

Again, because transactions between the grantor and the trust have no income tax consequences, the grantor is not taxed on interest payments he or she receives from the trust on the promissory note.

Because the grantor is treated for income tax purposes as if he or she still owns the trust assets, the grantor will report, for income tax purposes, all items of income, deduction and credit generated by the trust on his or her individual income tax return. Thus, if interest or dividends are received or capital gains are recognized in the trust, the grantor continues to be taxed on such items as though he or she had never sold the assets to the trust. The net effect of this income tax treatment is that the grantor is effectively able to make a tax-free gift to the beneficiaries of the trust, as the grantor's payment of income taxes reduces his or her estate without any transfer tax consequences while enhancing the assets that ultimately pass to the remainder beneficiaries by leaving the trust assets intact.

If the grantor dies while the note is outstanding and the trust exists, the income tax consequences are currently unknown. Given this uncertainty, if the grantor's death appears imminent, every effort should be made to pay off the note with appreciated assets during the grantor's lifetime. Because the trust is a grantor trust, no gain or loss would be recognized on the payment, and the appreciated property used to pay the note would be included in the grantor's estate and, therefore, would get a step-up in basis at the grantor's death.

An Example

Jim, age 50, transfers $100,000 to an irrevocable grantor trust. The income and principal of the trust are to be paid, in the trustee's discretion, for his daughter's health, education, support and maintenance. At his daughter's death, the trust assets will be held in the trust for the benefit of his grandchildren. Jim files a gift tax return to report the $100,000 gift to the trust (which is sheltered from tax by his estate and gift tax exemption) and allocates GST exemption to the transfer. After funding the trust, Jim sells $1,000,000 worth of assets to the trust in exchange for a 5-year $1,000,000 promissory note. The promissory note is structured so that interest is paid annually at the applicable federal rate of 5.12% and a balloon payment of principal is due at the end of the 5-year note. For illustrative purposes it is assumed that the trust assets will grow at a rate of 15% per year during the trust term.

As discussed, the initial funding of the trust with $100,000 results in a taxable gift. Nevertheless, if Jim's estate and gift tax exemption is available, the initial transfer can be sheltered from gift tax. No gain or loss is recognized on the sale of $1,000,000 of assets to the trust, and the annual interest payments of $51,200 ($1,000,000 x 5.12%) will not be taxable as income to Jim. At the end of the note term, the trust will pay Jim a balloon payment of $1,000,000, which also will not be taxable income to Jim. After the payment of the note, $867,283 will be left in the trust and will pass to the trust beneficiaries free of gift, estate and generation-skipping transfer taxes.

See the attached flowchart for an illustration of this example.

Frequently Asked Questions

What Happens if Total Return is Less Than the Applicable Federal Rate? If the trust assets appreciate at a rate that is less than the applicable federal rate (the "AFR") used to determine the interest payments on the promissory note, not only will the grantor receive back the value of the original property sold to the trust, but also some, or possibly all, of the assets gifted to the trust during the initial funding process. Thus, if the trust assets underperform, some of the grantor's assets will be subject to double taxation (*i.e.*, the gifted assets that are used to fund the note payments will be subject to gift tax upon funding the trust and to the estate tax at the grantor's death).

What if Total Return Exceeds the AFR, but the Income Generated by the Trust Assets is Insufficient to Pay the Interest on the Note? If total return exceeds the AFR, but the income generated by the trust assets is insufficient to pay the interest on the note (i.e., the assets have a high growth rate, but a low income yield), the trustee can transfer trust principal back to the grantor in order to make the annual interest payment. This method of payment is common where the assets sold to the trust are highly appreciating assets with low cash flow.

How Long Should the Note Term be? The term of the promissory note can be for any length. Generally, the longer the term, the smaller the required interest payment will be on the note. Because the death of the grantor during the note term only will result in the unpaid balance of the note being included in the grantor's estate (as opposed to the full value of the note), the grantor's survival of the term is not necessary to achieve transfer tax savings. In general, the length of the term will depend on interest rates at the time of the transaction (e.g., if the AFR is low, the grantor may want to lock in this rate by using a longer-term; alternatively, if the AFR is high, the grantor may want to use a shorter term and then enter into another sale transaction when rates are more favorable).

What Type of Assets Should be Transferred to an Intentionally Defective Grantor Trust? Generally, any assets with appreciation potential and/or yield in excess of the AFR are appropriate assets to sell to an intentionally defective grantor trust. Assets that can be valued at a discount, such as a minority interest in a closely held corporation, a limited partnership interest, or a large block in a publicly traded company, can produce significant savings because the face amount of the note will be based on the discounted value of the assets sold, rather than on the full value.

Can the Grantor Act as Trustee? The grantor cannot act as trustee of an intentionally defective grantor trust or exercise control over the trust. If the grantor were to act as trustee or exercise control over the trust, the trust assets would be included in the grantor's gross estate for federal estate tax purposes.

Can Additional Property be Sold to the Trust After the Initial Sale? Yes; however, before additional property is sold to the trust, the grantor should ensure that the trust has sufficient "other" assets to support the fact that the sale is a bona fide sale (*i.e.*, the grantor should ensure that the trust will have sufficient assets to satisfy the note payments in the event that the assets sold to the trust decline in value). If not, the grantor should gift additional assets to the trust prior to entering into another sale transaction.

Sale to an Intentionally Defective Grantor Trust vs. Grantor Retained Annuity Trust

Although a grantor retained annuity trust (a "GRAT") (See, "Grantor Retained Annuity Trusts," Article) offers similar transfer tax saving opportunities as a sale to an intentionally defective grantor trust, in that they both result in tax savings when the trust assets outperform (from an investment return perspective) the applicable interest rate, the sale technique will likely achieve superior leverage and transfer tax savings for the following reasons:

First, if the seller in a sale to an intentionally defective grantor trust dies before the promissory note is fully paid, only the unpaid balance of the note is included in his or her gross estate for federal estate tax purposes. Any appreciation in the value of the assets in the grantor trust escapes taxation. Conversely, if the grantor of a GRAT dies during the GRAT term, most or all of the GRAT property, including any appreciation in the value of the GRAT property, will be included in the grantor's gross estate for federal estate tax purposes.

Second, the annual annuity payments under a GRAT almost always will be greater than interest payments required under a promissory note used in a sale to an intentionally defective grantor trust because the interest rate for the GRAT is almost always higher than the interest rate on the note. As a result, more property will usually pass to trust beneficiaries free of transfer taxes under the sale technique than under a GRAT.

Third, the sale technique, unlike a GRAT, permits possible leverage of the grantor's GST exemption. This is because the tax law prohibition against allocating a grantor's GST exemption to a GRAT before its term of years expires does not apply to an irrevocable trust of the type used in connection with the sale technique.

Fourth, with the sale technique, it is possible to delay payments to the grantor, which has the effect of causing more growth to occur inside the irrevocable trust. In connection with a GRAT, there is a United States Treasury Regulation that limits the extent to which annuity payments may be postponed. Thus, unlike with a GRAT, by structuring the transaction as a sale to an intentionally defective grantor trust, it is possible to use a balloon note in which the repayment of principal is deferred until the end of the term of the note, thereby allowing the greatest compounding of appreciation inside the trust.

Although the sale technique has a number of advantages over the GRAT, the GRAT has one significant advantage over the sale technique in that it is a creature of statute. There is a provision of the Code, along with associated Treasury Regulations, that explicitly states what a GRAT is, what the rules are for creating and operating a GRAT and what the transfer tax consequences will be upon creating a GRAT. In contrast, no such certainty exists with respect to the sale to an intentionally defective grantor trust. The sale technique has been fashioned together based on a number of previously unconnected legal principles (*i.e.*, the technique was created based on logical connections and inferences that were drawn from court cases, published and private rulings by the Internal Revenue Service, Treasury Regulations and Code provisions). Thus, there is a risk that if the Service, in litigation involving the viability of a sale to an intentionally defective grantor trust, is able to successfully dislodge any of the key premises upon which the sale technique is built, the technique could lose its advantage (*e.g.*, the entire value of the trust property could be brought into the gross estate of the grantor for federal estate tax purposes). Despite this risk, the sale technique is a viable planning tool.

Conclusion

A sale to an intentionally defective grantor trust can likely achieve transfer tax savings that exceed the savings achieved by a GRAT. Nevertheless, the transaction is an aggressive technique.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information regarding defective trusts or any other estate planning options.